investigation uncovered a wide range of abusive practices on the part of banks and bank affiliates. These included a variety of conflicts of interest, such as the underwriting of unsound securities in order to pay off bad bank loans as well as ''pool operations'' to support the price of bank stocks.

The Pecora hearings galvanized broad public support for new banking and securities laws. As a result of the Pecora investigation's findings, the Congress passed the Glass-Steagall Banking Act of 1933 to separate commercial and investment banking; the Securities Act of 1933 to set penalties for filing false information about stock offerings; and the Securities Exchange Act of 1934, which formed the Securities and Exchange Commission, to regulate the stock exchanges. Thanks to the legacy of the Pecora Commission hearings and subsequent legislation, the American financial institution rested on a sound regulatory foundation for over half a century; that is, until we began the folly of dismantling it.

The Levin hearings have shined a much needed spotlight on the role of potential outright fraud by financial actors as well as the incompetence and complicity of bank regulators in the financial crisis. There is no better example of the danger that fraud and lax regulation poses to our financial system than the collapse of Washington Mutual Bank, known as WaMu.

Far too often, the failure of institutions such as Washington Mutual is blamed on high-risk business strategies. It kind of sounds all right, doesn't it? While such strategies are clearly part of the problem, they should not be used to mask other causes such as fraud and malfeasance which played a significant role in the collapse of WaMu. Evidence developed by the subcommittee demonstrates that WaMu officials tolerated, if not outright encouraged, fraud as a byproduct of promoting a dramatic expansion of loan volume.

The most blatant example of WaMu's culture of fraud was its widespread use of what are called stated income loans. Stated income loans is a practice of lending qualified borrowers loans without independent verification of what they state their income is. Listen to this. This is unbelievable. Approximately 90 percent of WaMu's home equity loans, 73 percent of its option ARMs, and 50 percent of its subprime loans were stated income loans. You go to the bank, you walk in, they say: Ted, what is your income? You say what it is, and that is it. Based on that, you can get 90 percent of WaMu's home equity loans, 73 percent of its option ARMs, and 50 percent of its subprime loans—stated income loans. As Treasury Department inspector general Eric Thorson said last week, WaMu's predominant mix of stated income loans created a ''target rich environment'' for fraud.

Because WaMu made these stated income loans with the intent to resell them into the secondary market, there was less concern whether borrowers would ever be able to repay them. WaMu created a compensation system that rewarded employees with higher commissions for selling the very riskiest of loans. In 2005, WaMu adopted what it called its high-risk lending strategy because those loans were so profitable. In order to implement this strategy, it coached its sales branch to embrace ''the power of yes.'' The message was clear. As one industry analyst has said: ''If you were alive, they would give you a loan . . . if you were dead, they would give you a loan.''

That this culture led to fraud on a massive scale should have surprised no one. An internal review by one southern California loan officer revealed that 83 percent of loans contained instances of confirmed fraud. In another office, 58 percent of loans were considered to be fraudulent. What did WaMu management do when it became clear that fraud rates were rising as house prices began to fall? What did they do? Rather than curb its reckless business practices, it decided to try to sell a higher proportion of these risky, fraud-tainted mortgages into the secondary market, thereby locking in a profit for itself even as it spread further contagion into our capital markets.

In order for WaMu and institutions similar to it to sell these low-quality loans to the secondary market, they need a AAA rating from credit rating agencies. So what did these institutions do? They gamed the system and manipulated the agencies by engaging in a practice called barbelling. Apparently, the credit rating agencies did not examine individual FICO scores when rating mortgage-backed securities and instead relied on average FICO scores. As revealed at the hearing by a WaMu risk officer and detailed in Michael Lewis's book ''The Big Short,'' lenders could create the requisite average score by pairing loans whose borrowers had relatively high scores with borrowers whose scores were far lower and would normally warrant a loan, which is the reason why it is called barbelling. So if the raters wanted an average FICO score of 615, a lender could compare scores of 680 with scores of 550, even though borrowers with scores of 550 were almost certain to default on the loan. This barbell effect satisfied the rating agencies, even though half the loans, in many cases, had little chance of success. At the hearing, WaMu's CEO, Kerry Killinger, effectively admitted to barbelling by saying ''I don't have the barbell numbers in front of me.''

To make matters worse, WaMu scored high FICO scores by seeking out borrowers with short credit histories. Such borrowers often have high FICO scores, even though they have not demonstrated the ability to take on and pay off large debts over time. These borrowers are called ''thin file'' borrowers. According to a report in the New York Times, WaMu encouraged thin file loans, even circulating a flier to sales agents that said ''a thin file is a good file.'' The book ''The Big Short'' even discusses a Mexican strawberry picker with an income of $14,000 and no English who was ostensibly given a $724,000 mortgage on the basis of his thin file.

Plainly, the Office of Thrift Supervision failed miserably in its responsibility to regulate WaMu and to protect the public from the consequences of WaMu's excessive and unwarranted risk-taking, including the toleration of widespread fraud. Although WaMu comprised fully 25 percent of OTS's regulatory portfolio, OTS adopted a laissez faire regulatory attitude at WaMu. Although line bank examiners identified the high prevalence of fraud and weak internal controls at WaMu, OTS did virtually nothing to address the situation. In fact, OTS advocated for WaMu, among other regulators, and even actively thwarted an FDIC investigation into WaMu during 2007 and 2008. The complete abdication of regulatory responsibility by OTS may find sad explanation in the fact that OTS was dependent on WaMu's user fees for 12 to 15 percent of its budget.

The regulatory failures at OTS were not unique. The overall regulatory environment at the time was extremely deferential to the market based on the widespread but faulty assumption that markets can and will effectively self-regulate. Self-regulate. At last Friday's hearing, the testimony of the inspector general at the Department of the Treasury was particularly noteworthy. He said bank regulators:

> . . . hesitate to take any action, whether it's because they get too close after so many years or they're just hesitant or maybe the amount of fees enter into it . . . I don't know. But whatever it is, this is not unique to WaMu and it is not unique to OTS.

Let me repeat. It was the conclusion of our Treasury Department's inspector general that the failure of regulators to harness the lawless nature of conflicted institutions was not unique to Washington Mutual or to the Office of Thrift Supervision.

I have said it before and I will say it again: It is time we return the rule of law to Wall Street, where it has been seriously eroded by the deregulatory mindset that captured our regulatory agencies over the past 30 years. We became enamored of the view that self-regulation was adequate, that enlightened self-interest would motivate counterparties to undertake stronger and better forms of due diligence than any regulator could perform, and that market fundamentalism would lead to the best outcomes for the most people. Some people even say that today. They say transparency and vigorous oversight by outside accountants is supposed to help our financial system—keep our financial system credible and sound. The allure of deregulation led us instead to the biggest financial crisis since 1929 and to former Federal Reserve Chairman Alan Greenspan's